BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

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01-02-07
04:59 PM

Order Instituting Rulemaking to Implement the Commission's Procurement Incentive Framework and to Examine the Integration of Greenhouse Gas Emissions Standards into Procurement Policies.	)))))	R.06-04-009 (Filed April 13, 2006)

COMMENTS OF BARCLAYS CAPITAL J. ARON & COMPANY MORGAN STANLEY CAPITAL GROUP INC.

ON PROPOSED DECISION ON PHASE 1 ISSUES

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January 2, 2007

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In accordance with Article 14 of the Rules of Practice and Procedure of the California Public Utilities Commission (the "Commission"), Barclays Capital, J. Aron & Company, and Morgan Stanley Capital Group Inc. (collectively "Filing Parties") respectfully submit these comments on the "Interim Opinion On Phase I Issues: Greenhouse Gas Emissions Performance Standard" ("Proposed Decision") issued jointly by President Peevey and Administrative Law Judge Gottstein on December 13, 2006, in the above-captioned proceeding.

Filing Parties file these comments in response to the Commission's determination that all long-term commitments be with specified sources in order to demonstrate compliance with the emissions performance standard ("EPS"). Filing Parties believe that such a restriction:

- is not based on the spirit or letter of Senate Bill ("SB") 1368;[1]
- could result in significantly increased costs for rate-payers; and
- could significantly impede reliability.

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[1] Stats. 2006, ch. 598, approved Sept. 29, 2006.

For the reasons described below, the Filing Parties urge the Commission to reconsider its prohibition on unspecified contracts with a term of greater than five years in the interim EPS period.

Moreover, although the Proposed Decision purportedly focuses on the interim EPS, the Filing Parties are concerned that certain provisions could have long-term detrimental effects on wholesale power markets in California and the West. For example, the draft decision states:

> [O]ther jurisdictions have developed specific resource tagging mechanisms to track generation attributes, including GHG emissions, of resources within their control areas. In particular, PJM Interconnection utilizes the Generation Attribute Tracking System and ISO New England utilizes the Generation Information System for this purpose. In addition, the CEC has under development the Western Renewable Energy Generation Information System for purposes of tracking compliance with California's RPS statute. *In our view, it is entirely feasible to implement a program that tracks the GHG emissions of all generating units, and that would enable marketers and other sellers of unspecified resource contracts to assign a reasonable and accurate GHG emissions profile to their contracts.* Over time, this should be the strategy pursued by California to deal with emissions from any unspecified resource contracts that LSEs may wish to pursue; however, as the record shows, this is not a likely pursuit for the types of LSE long-term procurements subject to the EPS.[2]

Unfortunately, the above conclusion is unsupported and contrary to the record evidence. The Filing Parties strongly believe that the best way to create a robust and viable long-term GHG market structure is to make it source-based, not load-based. The Filing Parties look forward to working with the Commission and other interested parties in Phase 2 of this proceeding to develop a comprehensive record that addresses and makes clear the implications of this most fundamental market design issue.

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[2] Proposed Decision at 123-124.

I. COMMENTS

A. Unspecified Long-Term Contracts Comport With SB 1368

The Proposed Decision maintains that the objectives of SB 1368 cannot be accomplished without requiring long-term contracts to be tied to specific generation sources.[3] The Filing Parties respectfully state that this is an overly broad and potentially damaging reading of SB 1368.

SB 1368 provides, in relevant part, that:

> [i]n developing and implementing the greenhouse gases emission performance standard, the commission shall address long-term purchases of electricity from unspecified sources in a manner consistent with this chapter.[4]

The Proposed Decision construes this provision to mean that "(1) LSEs only enter into long-term financial commitments with baseload generation that comply with EPS, and (2) EPS compliance cannot be achieved in a manner that would yield contrary result, i.e., that permits an LSE to enter into long-term commitments with high-emitting sources."[5] The Proposed Decision, however, does not support this construction of the statute.

As the Proposed Decision recognizes, the only section of SB 1368 that mentions unspecified contracts is the provision cited above.[6] That provision in no way requires a prohibition on long-term contracts as the Proposed Decision concludes. Rather, that provision requires the CPUC to address long-term purchases from unspecified sources "in a manner consistent" with the rest of the statute. The CPUC has now worked out rules for implementing SB 1368 for specified resources. To be in accord with the clear language of SB 1368, the CPUC

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3 Proposed Decision at 117.
4 § 8341(d)(7).
5 Proposed Decision at 117.
6 *Id.* at n149.

must now work out the rules for how the load-serving entities ("LSEs") are to implement SB 1368 for unspecified resources.

In sum, SB 1368 could have precluded LSEs from entering into contracts five-years or longer with unspecified resources. It did not. As a result, the Commission need not prohibit unspecified contracts as it has done in the Proposed Decision.

The Filing Parties recognize that the statute requires that all LSEs who enter into long-term financial commitments for baseload generation must ensure that the generation supplied "complies with the greenhouse gases emission performance standard *established by the commission.*"[7] Numerous parties suggested a variety of approaches to assign long-term contracts with unspecified resources an appropriate proxy or composite emissions standard that would meet both the spirit and the letter of the statute. Nevertheless the Proposed Decision rejects all of them finding that none of the specific proxy approaches "are reasonable or workable for our purposes, at least not at this time."[8] The Filing Parties respectfully suggest that SB 1368 obligates the Commission to develop a less draconian method for treating unspecified long-term contracts other than requiring their complete prohibition.

As described in greater detail below, the Commission's determination is based solely on hypothesized possible outcomes without giving due consideration to the adverse implications of such a ban on long-term contracts going forward.[9] Because of the significant harm associated with prohibiting unspecified long-term contracts, and because designing a proxy emissions standard does not violate the language or intent of SB 1368, the Commission should reconsider

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7 § 8341(a).

8 Proposed Decision at 119.

9 The Proposed Decision maintains that because attendees at the workshops indicated that the LSEs would be "entering into very few, if any, new contracts or contract renewals with unspecified contracts with a term of five years or longer," banning such contracts would not have a significant, impact on resource procurement flexibility. Proposed Decision at 122.

the Proposed Decision's prohibition. To that end, the Filing Parties urge the Commission to establish a separate working group[10] to address this issue on an expedited basis in early 2007. Numerous proposals were suggested in the comment period, but due to the tight time-frame to address issues in this proceeding, these proposals could use further vetting and consideration.

As the Proposed Decision recognizes, this EPS standard is interim in nature.[11] Developing a more appropriate method for considering unspecified long-term contracts at this phase would better serve the rate payers and the entire greenhouse gas initiative. Undeniably, such an approach comports with the language and intent of SB 1368.

B. Requiring Only Unit-Specific Contracts Is Uneconomic For Rate Payers

Requiring that all long-term commitments be with specified sources has the potential to cause economic harm to the ratepayers. The Proposed Decision recognizes that the design goals for the EPS include protecting California ratepayers from exposure to: (1) "the high costs of retrofits [to facilities] . . . under future emission control regulations;" and (2) "potential supply disruptions when these high-emitting facilities are taken off line for retrofits, or retired early, in order to comply with future regulations.[12]" However, prohibiting long-term transactions with unspecified sources does not comport with this goal.

First, ratepayers bear no such economic risk from unspecified resource contracts. Under such fixed-price contracts, the supplier necessarily bears all of the economic risks associated with the resources that underlie its supply to the LSE. Additionally, the supplier has no

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[10] This suggestion was also proffered by Pacific Gas & Electric Company in their comments on the Final Staff Recommendation Report.

[11] "Our adopted [EPS] is intended to serve as a near-term bridge until an enforceable load-based GHG emissions limit is established and in operation." Proposed Decision at 1.

[12] *Id.* at 3.

mechanism for passing on any future compliance-related costs other than as may have been bilaterally negotiated.

Second, suppliers of unspecified contracts with terms of more than five years, and not the ratepayers, bear all of the "disruption" risk under the contract. Simply stated, if an unspecified unit is unavailable for any reason, including retrofitting, early retirement, or compliance with future regulations, the supplier would be required to find power supply from an available unit, and bear all of the economic and performance risk under the contract.

As such, there is no logic behind limiting contracts with unspecified resources to protect ratepayers, because such contracts in fact provide the HIGHEST level of protection, and provide the best hedge against the very risks that SB 1368 aims to address.

Furthermore, by requiring that LSEs can only enter into unit-contingent contracts after February 1, 2007, the Commission effectively eliminates a whole class of supply contracts that could help reduce power costs for ratepayers. Suppliers that do not specify resources are taking an approach to the market that emphasizes system knowledge, nimbleness, flexibility, intermediation, and risk management in an effort to always use the best available source to meet a contractual obligation in a complex, ever-active, creative and flexible manner. In some instances it may seem counterintuitive that an entity that does not own physical generation units could supply power at a lower price than a company that owns and operates actual generation resources. However, it is the case that power marketers may offer the cheapest source of supply, as evidenced by the fact that power marketers have successfully bid for contracts to supply power to load serving entities. By arbitrarily eliminating power marketers from competition, California consumers are deprived of the benefits of their lower cost options.

Finally, the Proposed Decision maintains that a ban on long-term unspecified resource contracts greater than five years will not adversely affect the requisite flexibility that an LSE needs, because LSEs "would be entering into very few, if any, new contracts or contract renewals with unspecified contracts with a term of five years or greater."[13] The Proposed Decision takes this data on its face without understanding why LSEs might have avoided entering into such contracts in the current environment. What the Proposed Decision fails to consider is that LSEs may very well have avoided entering into *any* long-term contracts, pending the finality of the Commission's rules for procurement that will result from the Long-Term Procurement rulemaking. In fact, careful review of the recently filed Long-Term Procurement Plans by the LSEs reveals that all three LSEs are planning to enter into new contracts to replace their California Department of Water Resources ("CDWR") contracts that are terminating at the end of the decade. Each of the LSEs has specified that they plan on replacing the CDWR contracts with contracts from the market or from existing generation.

C. Prohibiting Unspecified Long-Term Contracts Threatens System Reliability

The Proposed Decision's prohibition of unspecified long-term contracts will effectively force all long-term supply contracts to become unit-specific supply contracts. There is, however, an unintended consequence for system reliability that will result from relying on such unit-specific long-term contracts. The Commission should consider this adverse impact on system reliability before effectively requiring all long-term contracts to be unit-contingent arrangements.

The proposal to prohibit unspecified long-term contracts in the Proposed Decision has parallels to the recent proposal by the Federal Energy Regulatory Commission ("FERC") to revise their regulations governing network resources under the *pro forma* Open Access

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[13] Proposed Decision at 121.

Transmission Tariff ("OATT"). There, FERC proposed to require that for a power purchase agreement to qualify as a network resource under the OATT, it must specify a single source of supply. FERC received numerous comments on this issue advising that flexibility is necessary on this matter, for the same reasons that flexibility is necessary in the EPS for unspecified long-term contracts.

In the FERC proceeding, Arizona Public Service Company ("APS") filed detailed comments on the network resource issue, citing various reliability concerns that are particularly relevant in the instant proceeding.[14] All of the concerns for system reliability cited by APS are analogous here. For example, APS noted the need for flexibility when a firm power purchase agreement with delivery at a liquid trading hub could be sourced from several different units, without impacting the firmness of the resource. APS also noted the role of non-utility market participants, like Barclays, J. Aron, and MSCG, who may not have a "system" or own generating resources, but have solid credit.[15] In this circumstance, a financial institution can enter into a long-term sale arrangement with an LSE and meet the supply requirements under the agreement by purchasing a variety of resources that would not otherwise be available to the LSE due to credit matters. Although that long-term agreement may not be able to specify a generating unit on a long-term forward basis,[16] it ensures system reliability at least as well as any unit-contingent contract.[17]

As APS also noted in its comments to FERC, requiring sellers to unnecessarily commit specific resources long before delivery is required will reduce market liquidity and reliability.

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[14] An excerpt of APS's comments is attached hereto as Exhibit A.

[15] Exhibit A at 36.

[16] All "unspecified contracts" become "specified" in the Day-Ahead timeframe, through the resource scheduling and tagging process.

[17] *Id.* at 37.

Specifically, unspecified resource liquidated damages contracts are critical to LSEs, so long as they are physically firm, because they allow parties to settle on damages without litigation. As a result, those contracts historically are the most reliable. APS, for example, states that firm power purchase agreements typically have the highest availability of any network resource; indeed, APS experienced a 100% physical delivery rate for firm power purchases in the twelve months ending in June 2006, compared with an average availability of approximately 92.5% for owned generation, and a 76.8% rate for unit-contingent contracts.[18] As is evident by APS's data, unit-contingent contracts are the least reliable arrangement, as compared with long-term unspecified power purchase agreements, which are the most reliable. It only follows, then, that the Proposed Decision's prohibition on such contracts could serve to negatively impact reliability in the California markets.

II. CONCLUSION

For all of the aforementioned reasons, the Filing Parties respectfully request that the Commission reconsider the finding in the Proposed Decision prohibiting unspecified long-term contracts greater than five years.

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[18] *Id.* at 38.

Respectfully submitted,

/s/

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January 2, 2007

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of "Comments of Barclays Capital, J. Aron & Company, and Morgan Stanley Capital Group Inc. on Proposed Decision on Phase I Issues" by transmitting an e-mail message with the document attached to all parties of record in R.06-04-009.

Dated at Washington, D.C., this 2nd day of January, 2007.

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EXHIBIT A

be to the benefit of all customers. A Commission policy that allows such flexibility will ensure that unnecessary transmission plant is not built and that transmission provider's scarce capital is used to fund projects that will be used and useful.

The Commission's existing policy allows the transmission provider to limit a transmission customer's right of first refusal by reserving capacity to accommodate reasonably forecasted and verifiable native and network load growth at the time the initial service agreement is executed.[60] There may be some uncertainty regarding the transmission provider's obligations in instances where the transmission provider exercises its right to limit the rollover obligation. The Pinnacle West Companies interpret the policy to mean that where the transmission provider limits the term of the rollover provision, the transmission provider has no obligation to provide transmission service or to build transmission facilities after that date. The transmission customer would have the obligation to request further transmission service and to request and pay for any needed studies should new facilities need to be built. The Pinnacle West Companies request clarification that this interpretation is correct.

4. Designation of Network Resources

a. Qualification as a Network Resource

The NOPR discusses which power purchase agreements may be designated as network resources by network customers.[61] The Pinnacle West Companies believe that clarification of this issue is becoming increasingly important as load serving entities rely more on power purchase agreements to meet load serving obligations, and not just for economy energy. For example, APS's 2006 peak load was greater than 7,700 MW

[60] *See* NOPR at ¶ 349.
[61] *See* NOPR at ¶ 407.

compared to APS-owned generation of approximately 6,100 MW. Given this net short position, APS relies heavily on both unit-contingent and firm purchased power agreements to meet its load-serving obligations, in addition to making purchases of economy energy when prudent. It is very important that the clarification of network resource requirements in the NOPR not unnecessarily reduce liquidity in wholesale power markets or eliminate potential counterparties that are not traditional utilities or merchant generators.

Specifically, the NOPR suggests that a power purchase agreement must specify a single source of supply and control area or it cannot meet the network resource designation requirements in Section 29.2(v) of the *pro forma* OATT.[62] The Final Rule should recognize that the level of detail required by Section 29.2(v) may vary depending on circumstances, and permit the transmission provider to determine the level of information necessary to allow the transmission provider to study and evaluate the network resource. For example, a firm power purchase agreement with delivery at a liquid trading hub, such as Palo Verde, could be sourced from several control areas (including some generator-only control areas) and from several different power plants without impacting the transmission provider's analysis of the network resource. In this circumstance, the network customer should be allowed to provide a more general description of the purchase when responding under Section 29.2(v).

Because of the current credit environment in the industry, it is particularly important to recognize the role of non-utility market participants, such as financial institutions. These market participants may not have a "system" or own a generating plant, but may have very good credit quality. Thus, a financial institution can enter into a

[62] *See* NOPR at ¶ 402.

long-term sale arrangement with a load serving utility, and meet its supply requirements under the agreement by purchasing a variety of resources that would not be available to the utility directly due to credit issues. Although such a long-term power purchase agreement may not be capable of immediately showing a "system" or specific unit, it could be just as reliable a resource as a utility-owned power plant or unit contingent contract.[63]

Clearly, there are circumstances where specificity is needed by the transmission provider to evaluate a proposed network resource. However, requiring a seller to unnecessarily commit to specific sources or control areas for such a power purchase agreement long before delivery is required will reduce market liquidity and adversely affect utilities that are seeking to purchase for network loads. The Pinnacle West Companies believe that the Final Rule should recognize that while the information required by Section 29.2(v) must be provided, the level of detail required by Section 29.2(v) could vary depending on the specific circumstances and the description of a proposed power purchase agreement may, in some cases, appropriately refer to more general information than a specific single control area or single source of supply.

Similarly, the Final Rule should continue to recognize that a power purchase agreement containing a liquidated damages clause may still be designated as a network resource if it is a physically firm product. Liquidated damages provisions are critical to load serving entities like APS because they allow parties to settle on damages without

[63] Sellers would continue to be prohibited from selling non-firm power as "firm" and for complying with any network resource designation or undesignation requirements relating to the sale.

litigation. However, the mere presence of a liquidated damages clause does not mean that a contract is interruptible for economic reasons.[64]

Power purchase agreements with load serving entities often specify very limited circumstances under which a seller can refuse to deliver, such as a force majeure, even though they contain a liquidated damages clause to measure damages in case of a breach of contract. "Firm LD" contracts, such as the Western Systems Power Pool Schedule C contract, are not interruptible for economic reasons. In practice, firm power purchase agreements typically have the highest availability of any network resource—100% of APS's firm power purchases were physically delivered in the twelve months ending in June 2006, compared to an average availability of approximately 92.5% for owned generation and 76.8% for unit-contingent contracts. Also, at least in the West, counterparties that agree to deliver firm products are expected to deliver these products rather than simply offer financial compensation through liquidated damages. A utility such as APS that depends on power purchase agreements to meet its load will stop transacting with a counterparty that develops a track record of failing to deliver firm power.

Accordingly, the Final Rule should continue to recognize that physically firm power purchase agreements with liquidated damages provisions can be designated as network resources.

b. Documentation for Network Resources

The Pinnacle West Companies agree with the Commission's clarification that transmission providers not be required to verify that the network customers' generating

[64] *See, e.g., Dynegy v. Commonwealth Edison*, 101 FERC ¶ 61,295 (2002) (recognizing that "Firm LD" contracts are appropriately considered network resources and that liquidated damages provisions are remedial in nature).

units and power purchase agreements satisfy the network service requirements set forth in sections 30.1 and 30.7 of the *pro forma* OATT.[65] We believe that the responsibility is properly placed on the network customer.

Thus the Pinnacle West Companies are not opposed to requiring that the network customers be required to submit attestations concerning the qualification of their generators and power purchase agreements as network resources.[66] However, we believe that customers should make such attestations in good faith, such that an inadvertent error or omission would not automatically result in recourse to a legal remedy if it can be corrected without adverse impacts.

The Pinnacle West Companies do not agree that transmission providers should be responsible for verifying the firmness of the network customers' transmission arrangements on other transmission systems.[67] The transmission customer should have the obligation to ensure that their transmission arrangements meet the requirements needed to ensure that their resources qualify as designated network resources, just as they should have the obligation for the resource itself. It may be both difficult and impractical for the transmission provider to insert itself into a customer's other commercial arrangements to make such a determination.

c. Undesignation of Network Resources

In the NOPR, the Commission proposes to continue to allow network customers to undesignate a portion of their network resources on a short-term basis to make off-system sales.[68] The Pinnacle West Companies support this proposal.

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[65] *See* NOPR at ¶ 412.
[66] *See* NOPR at ¶ 413.
[67] *See* NOPR at ¶ 412.
[68] *See* NOPR at ¶ 422.

Later, in the same paragraph, however, the Commission states that, "The network customer, including the transmission provider itself, can request to redesignate the resource by making a request to designate a new network resource pursuant to section 30.2 of the *pro forma* OATT."[69] The Pinnacle West Companies request clarification that the Commission does not seek to make this an unduly burdensome process. If an unduly burdensome process is imposed, it may be impractical for network customers to undesignate their network resources. In instances where all or part of the financial benefits of these sales are passed onto end-use customers, such as through a fuel adjustor crediting mechanism, end-use customers could be adversely impacted. It could also have a detrimental effect on the wholesale market by reducing the number of sellers.

The Pinnacle West Companies also request clarification that short-term undesignations do not impact the customer's queue position for the hours that have not been undesignated. In other words, a network customer could undesignate a network resource for the term of the off-system sale, while retaining the network designation thereafter. This is similar to the Commission's practices with respect to redirecting point-to-point transmission service and the retention of the primary path.

The Pinnacle West Companies support a requirement that the short-term undesignation and redesignation of a resource be done on OASIS and the development of the business practices and the associated S&CP requirements through NAESB. As explained further below, the Pinnacle West Companies request that the Commission allow sufficient time for the NAESB process, Commission approval of the NAESB business practices and S&CP requirements, and the incorporation of the new OASIS software requirements by the transmission providers or their OASIS vendors.

[69] *See Id.*

In the NOPR, the Commission seeks comment on the amount of time prior to operation that the transmission provider and other network customers should be required to terminate a network resource to ensure that the appropriate set of network resources are included in the ATC calculation.[70] The amount of time prior to operation required to terminate a network resource should be consistent with the frequency of the ATC calculation on OASIS. If the undesignation and redesignation are performed on OASIS, as proposed above, the ATC on APS's OASIS could be recalculated and posted immediately following the undesignation or redesignation.

5. Clarifications Related to Network Service

In the NOPR, the Commission proposes to modify the *pro forma* OATT to clarify that a network customer may use secondary network service to deliver economy energy,[71] and the Commission proposes to define "economy energy" as "energy purchased by a network customer that displaces the customer's own higher cost generation for the purpose of serving the customer's designated network loads."[72] The Commission also proposes to clarify that a network customer may not use secondary network service to support an off-system sale if the purchased power does not displace the customer's own higher cost generation.[73]

The Pinnacle West Companies agree that network transmission service should not be used to support off-system sales, but strongly support EEI's comments urging that secondary service not be limited to only "economy energy." At peak hours, APS may be purchasing resources that are not "economy energy" but would still be used to serve load.

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[70] *See* NOPR at ¶ 423.
[71] *See* NOPR at Appendix B *Pro Forma Open Access Transmission Tariff*, Section 28.4.
[72] *See* NOPR at ¶ 427.
[73] *See* NOPR at ¶¶ 427, 429 and 430.